

Strengthening America's Economy

The President's Jobs and Growth Proposals

Council of Economic Advisers

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The Economic Situation

The U.S. economy continues to recover from the recession and exhibits strong long-run fundamentals. Inflation remains low. Productivity growth remains strong, suggesting that the post-1995 acceleration in productivity will continue to raise real incomes and living standards.

The recent recession stands apart from the typical postwar recession in that household income growth has been stable while stock price declines have eroded household wealth. In the typical recession, incomes and net worth move together, but in the most recent recession net worth fell dramatically relative to income.

Declining equity prices also raise the cost of capital for investment. Lower share prices mean that firms must sell a larger share of the company to raise a given amount of cash to finance new investment. In addition, lower stock prices mean higher leverage – the ratio of the market value of equity to outstanding debt – possibly increasing firms' cost of raising debt-financed capital. A higher cost of capital will cause firms to reduce investment spending.

Household spending, notably on autos and housing, has played a key role in the recovery thus far. Spending has been supported by the continued growth of real personal income – which has been more resilient than in previous business cycles – owing in part to the tax cut in 2001, and supportive monetary policy. Low interest rates have contributed to special financing incentives for automobile purchases and low mortgage interest rates. In November, new home sales were at a record level.

While the economy is growing, a stronger recovery depends on a robust rebound in business investment. A plunge in investment that began in the last half of 2000, along with the declines in equity markets, was an important force in the recession. While purchases of equipment and software has picked up modestly, new orders for non-defense capital goods – a forward-looking indicator of investment – fell in November. New orders remain below shipments of capital goods, also suggesting soft investment. And high office and industrial vacancy rates continue to depress investment in commercial structures.

A recovery in investment is a key factor in creating more jobs because when companies build new factories, they hire directly and boost employment in capital-goods industries. Thus far in the recovery, the labor market remains a weak spot, reflecting the state of business investment, with the unemployment rate reaching 6.0 percent in November. Most private forecasters believe that business investment will rebound, bringing along with it the job creation needed to reduce the ranks of the unemployed. At the same time, household spending is expected to continue its upward trajectory. In short, the consensus private forecast shows a steadily rising rate of GDP growth over the course of 2003 and continued strong growth in the year after.

In this setting, the goal of the President's proposals is to enhance long-term growth while providing near-term support against downside risks. Even if the recovery takes shape as these forecasters anticipate, the United States will benefit from policies to enhance the rate of long-term growth. Moreover, there are potential risks to the recovery, including an investment recovery that is delayed or more anemic than anticipated by professional forecasters. Threats to the investment recovery include weaker-than-expected profit growth, high required rates of return arising from geopolitical and other risks, or a prolonged period of balance-sheet repair. More general risks include an increased sense of caution that leads families to pull back on their spending plans, and the potential for further terrorist attacks. Indeed, some of these risks could become linked; for example, if firms become uncertain about the strength of consumer demand and put investment plans on hold.

The President's Proposals

The President has proposed a focused set of initiatives to raise long-term growth and strengthen our economy against potential risks. Specifically:

1. Accelerate to January 1, 2003 features of the 2001 tax cut currently scheduled to be phased-in: the reductions in marginal income tax rates, additional marriage penalty relief, a larger child credit, and a wider 10 percent income tax bracket.
2. Eliminate the double taxation of dividend income by excluding dividends from individual income taxes.
3. Increase to \$75,000 the size of small business investment incentives – the amount that they may deduct from their taxes in the year the investment takes place.
4. Provide \$3.6 billion of funds to the states to fund Personal Reemployment Accounts.

Macroeconomic Impacts of the President's Proposals

Enacting the President's proposals would have a significant effect on the rate of long-term economic growth, as well as provide near-term support for the recovery (see below). GDP growth would be 0.4 percentage points higher in 2003, and 1.1 percentage points faster in 2004. Over the five year period 2003 to 2007, GDP growth would be 0.2 percentage points higher on average. Faster GDP growth also means job creation – 190,000 new jobs in 2003 and 900,000 in 2004. With this additional employment growth, the economy is expected to generate 2 to 3 million jobs each year over the next three years.

The table includes two estimates of the impact of the President's proposals on the Federal budget. The first estimate follows conventional budget scoring and assumes that the overall level of GDP is unchanged by the policy. The second estimate incorporates the impact of faster economic growth on overall Federal receipts. The final row in the table shows the impact of the overall policy on the ratio of debt to GDP. While the proposal initially raises the ratio of debt to GDP, after 2007 it begins to decline and faster growth eventually returns the ratio to the same level as in the absence of the policy proposals.

The President's Proposals and the Economy			
Impact of President's Proposals:	2003	2004	2003-2007
Faster Real GDP Growth (percentage points, calendar year)	0.4	1.1	0.2 [*]
Additional Employment Growth	190,000	900,000	170,000 [*]
Lower Unemployment Rate (percentage points)	-0.1	-0.6	-0.5
Change in Surplus; No Impact of Faster Growth (\$ Billions, fiscal year)	-33	-113	-359 ⁺
Change in Surplus; Including Impact of Faster Growth (\$ Billions, fiscal year)	-31	-88	-166 ⁺
Additional Federal Debt Relative to GDP (percentage points, fiscal year)	1.0	1.8	2.0
[*] Average, 2003-2007. ⁺ Total, 2003-2007.			

Modeling Details

The particular values of the numerical estimates reflect judgments regarding the implementation of the proposals, often with little information regarding the most likely outcome. For example, the estimates reflect the assumption that policies are enacted and begin to affect the economy at the beginning of the third quarter of 2003, but not before.

Many commentators have argued that eliminating the double taxation of dividends would provide a substantial boost to stock prices, perhaps raising consumption spending and adding to the short-term support for the economy. In the interests of being conservative in the analysis, however, it is assumed that the proposals have no direct impact on equity markets.

Another important assumption is that the numerical estimates discussed below assume no changes in the stance of monetary policy. Although the exact path of future policies cannot be forecast, the President's proposals will be most valuable in the event that downside risk scenarios come to pass, which are also circumstances in which it is least likely that the effects of the policy would face offsetting interest rate movements. To the extent, however, that this fiscal insurance proves unnecessary, any potential tightening of monetary policy would partly offset the impacts shown below.

Finally, when computing the impact of faster growth on Federal budget receipts, we follow the historical evidence and assume that a \$1 rise in real GDP generates 20 cents of Federal revenue. In contrast, to the extent that nominal GDP rises strictly due to higher prices, only 16 additional dollars are received in nominal Federal revenues.